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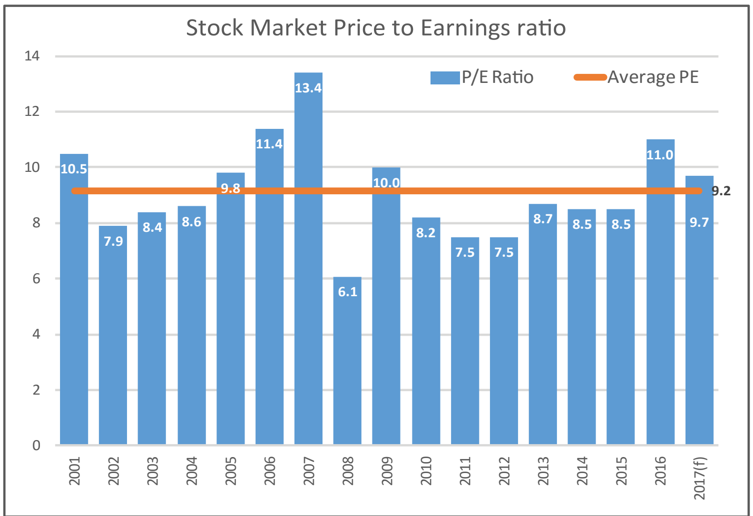
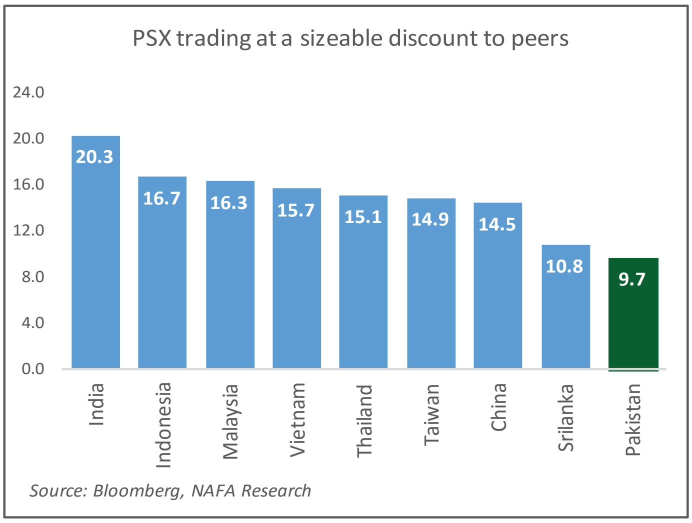
Is it time to invest in the stock market?

After delivering a staggering return of 46% in CY16, the stock market has depicted lukewarm performance amid a lot of volatility during January-July 2017 period, with the benchmark KSE index declining by around 4%. Many positive developments such as PSX upgrade into MSCI EM index effective June-17, CPEC related investment activity gathering pace, benign inflation & interest rates, and healthy economic growth were outweighed by negative developments: (i) rising domestic political uncertainty with the start of court proceeding against the Prime Minister in January 2017 in the Panama Leaks Case; (ii) renewed decline in the global oil prices that weighed in on the index heavy Oil & Gas and Banking sectors; (iii) SECP's drive to curb in-house badla financing that crimped market liquidity; and (iv) rising risks to the Balance of Payment Position (BoP) from widening trade and current account deficits. Investors preferred to sell-off some positions amid elevated domestic political fluidity during the last couple of months that culminated in the dismissal of Prime Minister Nawaz Sharif on July 28, 2017 by the Supreme Court bench over mis-declaration of assets.

Spooked by the sharp recent correction and elevated volatility, investors are pondering whether the stock market has run its course? While we acknowledge that the economic and political risks have increased, we believe that the stock market still holds the potential to deliver attractive returns. Courtesy of a substantial correction of 13% from its peak, valuations have become attractive with the Price to Earnings ratio dropping to about 9.7 times compared to the recent peak of 11 times based on forward earnings. Corporate earnings continue to show healthy double digit growth supported by key sectors such as steel, cement, and power on account of capacity expansions; and Oil & Gas Exploration sector driven by recovery in global oil prices and some expected PKR depreciation. On the economic front, we expect the annual GDP growth rate to again cross 5% in FY18 as projects under CPEC gather pace and domestic consumption remains strong. We expect inflation and interest rates to remain anchored with modest pick-up of 75-100 basis points during FY18. However, current account deficit rising to USD12.1 billion in FY17 from USD4.9 billion in FY16 is a potential risk to the macroeconomic stability, and headwind for the stock market if left unaddressed. With foreign exchange reserves still equivalent to 17 weeks of imports, we don't see imminent Balance of Payment crisis, but endorse the view point that among others measures some currency devaluation is needed to arrest non-essential imports and alleviate exporters' concern by partially restoring competitiveness.





Going forward, some Pak Rupee devaluation and diminished political noise are likely to become catalysts for domestic and foreign buying in the stock market, as the market is attractively valued vis-à-vis other emerging & regional markets (see chart above). We advise investors with a year or more investment horizon to investment via stock mutual funds with a good performance track record.